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DE RUEHMO #1442/01 0920750
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FM AMEMBASSY MOSCOW
TO RUEHC/SECSTATE WASHDC PRIORITY 8840
INFO RUEHZL/EUROPEAN POLITICAL COLLECTIVE PRIORITY
RUCPDOC/DEPT OF COMMERCE WASHDC PRIORITY
RHEBAAA/DEPT OF ENERGY WASHDC PRIORITY
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
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C O N F I D E N T I A L SECTION 01 OF 04 MOSCOW 001442

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STATE FOR EUR/RUS; EUR/ERA; EEB/IFD
STATE PLS PASS USTR FOR DONNELLY, MOLNAR
NSC FOR KLECHESKI AND MCKIBBEN
DOC FOR 4231/IEP/EUR/JBROUGHER

E.O. 12958: DECL: 04/02/2017
TAGS: ECON EINV EIND PGOV RS
SUBJECT: RUSSIAN CORPORATE STATISM: WATCH THIS SPACE

REF: 06 MOSCOW 1306

Classified By: Ambassador William J. Burns for reasons 1.5 (b/d)

¶1. (C) Summary: The rise of corporate statism in Russia has been significant. Since 2004, the government has taken over the world's largest titanium business, consolidated its position in Gazprom, merged 10 aviation businesses into a state-owned conglomerate, and taken controlling positions in other firms. No less fascinating has been the mix of greed, politics, and business behind the expansion of the state into the economy. Looking ahead, our contacts are strongly divided. Some see troubling signs of continued state ambition. Others believe the process is essentially plateauing, and will stabilize at lower levels of state ownership in the economy after two-three years. In our view, the current trendline may quickly approach some rather natural limits, and the Kremlin will eventually have to bow to the market. In the meantime, we should reinforce market-driven approaches and the cadre of Russian policy-makers who doggedly keep these ideas in play. End Summary.

¶2. (SBU) This cable is based on dozens of conversations with contacts in industry and banking over the past six weeks, supplemented by Embassy-based research.

## The Breadth of State Ownership

¶3. (SBU) The march of the state into parts of the Russian economy over the past few years has been significant, with control of swaths of the natural resource, defense, and select other sectors consolidated in state hands. Annual revenues of Russia's ten largest state-owned or controlled companies reached an estimated 20 percent of GDP in 2006. State-owned or controlled companies account for one-third of the Russian stock market's capitalization, and in just the last year, the value of these equity holdings has almost doubled to an estimated USD 369 billion. And the process continues: Rosoboronexport is rumored to be in line to buy Russia's fifth largest steel producer, Mechel; further consolidation in the energy sector favoring Gazprom and Rosneft is likely; a new shipbuilding national champion is in the works; and diamond giant Alrosa has its eye on Norilsk Nickel, a USD 30 billion company with more than the half the world's palladium and one-fifth of global nickel output.

## Looking Behind This Latest Great Grab

¶4. (C) The grab for Russia's resources is an old story, but contacts agree that traditional motives (greed, power) have been supplemented in this round with a nationalistic brand of commercial considerations. Greed in Russia shocks no one, but the rising value of Russia, Inc. (on the back of high energy prices) has made the current grab particularly profitable for some. Power considerations -- both geopolitical (as in the case of Gazprom) and in the context of Russia's domestic succession process -- are evident as well. New to this paradigm is the surprisingly strong role business considerations seem to be playing -- as the Russian Government tries to salvage a select few decrepit remains of Soviet industrial prowess before it is too late. Our contacts have a lot to say about all three motives; we summarize what we've heard here.

¶5. (C) Greed: The Kremlin leadership in the economy is in no small part about money, and the Sibneft takeover by Gazprom is perhaps the most blatant example of this (only about a quarter of the $12b selling price for the firm is said to have actually gone to owner Abramovich). In general, the insider offtake from M&A deal flows is said to be so large now that Swiss banks have told Kremlin cutouts (like gas-trader Timchenko) that they cannot accept further deposits without knowing the source of the money. The most lucrative transfers to the state (usually involving natural resources) may be wrapped in patriotic rhetoric, but include a healthy dose of financial opportunism. Yet, as ugly as it looks, our contacts remind, it is not so different than what happened in Indonesia and South Korea - and Mexico too. As one contact points out, "the bureaucrats got rich there too."



¶6. (C) Power: Creating national champions and projecting a strong image for Russia abroad has been a leading factor in many state-connected takeovers and consolidations, including the removal of the Gazprom ring fence, the Rosoboronexport makeover, the RUSAL-SUAL deal, and the anticipated takeover of Norilsk Nickel by Alrosa. Some of what we are seeing is also is part of the ongoing succession process, putting individuals into deal flows and thus providing campaign finance and enhancing their public profile. The decision to put military hardware exports under Rosoboronexport is seen in some quarters as buttressing dark horse presidential hopeful and Rosoboronexport Chairman Sergey Chemezov. Recent portfolio changes are seen by some as giving First Deputy Prime Minister Sergey Ivanov a cash-laden institutional base like that enjoyed by his chief rival for the presidency, First Deputy Head of the Presidential Administration and Gazprom Chairman of the Board of Directors Dmitriy Medvedev.

¶7. (C) Nationalistic-Driven Commercial Considerations: Many believe that Putin and those around him are also driven by a sincere desire to right the excesses of the 1990s, or oligarchic plundering of once-proud, though ruinously inefficient, Soviet companies. The examples here are truly varied. In the case of Avtovaz, Rosoboronexport's move to take over the firm last year may be the only thing saving the car-giant from complete collapse in the face of global competition. The emerging Norilsk Nickel story is said to be as much about saving Alrosa (which experts say will run out of diamonds in ten years' time) as it is about keeping Norilsk's palladium and nickel output in Russian hands. And, as driven by national security concerns as the formation of the United Aircraft Company might be, also at play is a long-overdue consolidation of an industry largely on the verge of collapse. These examples are more about saving jobs and communities and creating viable competitive companies than personal enrichment. Although making money is not precluded here, both Avtovaz and UAC, not to mention plans to create a new shipbuilding national champion, sound more like cash sinks than cash cows.

## What Next?

¶8. (C) Looking ahead, our contacts are divided about what to expect next. "Statist" believers argue that there are troubling signs that the trend is far from contained: state-owned companies are straying farther from their core business, eyeing the telecom and IT sectors, and expanding beyond traditional financial services. They point to Gazprom's movement into electricity; Svyazinvest's significant stake in privately-held telecom provider Comstar; and VneshTorgBank's overtures to brokerage house Troika Dialog (ultimately rebuffed). While no one is predicting another Yukos-style approach, there is a sense that the authorities can and will come up with new pretexts for control.

¶9. (C) In contrast, others argue the state's reach is plateauing, and the current mix of state-private ownership could start to reverse itself before long. They say national champions in the sectors that make sense have been created, and industries such as telecom and IT do not lend themselves to over-centralization. In gas and electricity, given supply shortfalls, the GOR has to promote private investment to meet demand and introduce efficiencies. A shrinking current account balance (on the back of lower oil prices) and the drive to diversify the economy only heighten the need for private capital and better corporate governance (which implies a move away from state ownership and control). The Kremlin will also find it increasingly difficult to control emerging interest groups, from the consumer sector to regional governments. Integration into the WTO and other western economic institutions will require greater transparency, better and more equal market access, and lower protectionist barriers - which will temper the state's ambition.

¶10. (C) Some take this latter argument one dark step further. They say that current GOR leadership, its successors and supporters, will need to find outlets for their accumulated wealth, much of which is said to be held in liquid assets abroad. The theory goes that these funds will start making their way back to Russia over the next two-three years, and that the target of the return flows will most likely be the



same assets that have been carefully squirreled away in state hands over the past few years -- thus spurring share offerings by Rosneft, spin offs at Gazprom, etc. These assets are profitable, and equity ownership in Russia carries less risk for this particular group of investors than the prying eyes of regulatory authorities abroad. Likewise, coming into Russia from an European investment platform, as one contact cynically noted, may make it less likely that zealous law-enforcement officials abroad would pursue criminal or civil cases for fear a U.S. or European firm could get tangled up in the investigation.

## Where We Come Out

¶11. (C) Looking at the three motives most obviously at play, two of them -- greed and nationalistic commercial considerations -- suggest equally valid reasons why we might see the state pulling back from its commanding heights over the next few years. Greed will tend to push those who have accumulated shares in state companies towards share cash-outs, just as it will push those who have accumulated "private" cash abroad to buy back into Russia's safest investments. Rosneft is a perfect example. We are watching to see who in the government argues the loudest for Rosneft's further privatization -- they more than likely stand to benefit from either the sell or the buy opportunity. For industries that are less obvious moneymakers, exemplified by Avtovaz and UAC, the state is even more likely to divest (wholly, in the case of Avtovaz) as the firms become commercially viable and need investment capital and strategic partners, and as they become less social land mines and resemble more the typical day-to-day slog of the business

world.

¶12. (C) But pulling back does not mean exiting the field. XXXXXXXXXXXX does not expect the state ever to relinquish its control of XXXXXXXXXXXX. Nor will the GOR allow its stake in Gazprom to drop again below 50%, although many predict it will shed non-core assets in the coming years. Nor will the diamond trade or trade in metals likely see a repeat of the halcyon days of private ownership in the wake of loans-for-shares. UAC will likely never be more than 30% privately-owned.

¶13. (C) But even if every firm in the natural resources sector ends up in state hands, as significant as that would be, it would account for around 12% of the Russian economy. Add in state monopolies in the transport and communications sector, defense industries, and space, and state control over the economy rings in around 25% of GDP. As disturbing as this figure might seem, it is not wildly out of line with other market economies rich in natural resources. As recently as two years ago, the Norwegian state owned approximately 32% of the companies listed on the Oslo Stock Exchange, and still holds shares in 10-15 percent of Norwegian industry, including controlling shares in oil, telecoms, and the national airline. In Mexico, the state fully controls the oil, gas, and nuclear power industries and has reserved for the state in whole or part the telecommunications, air travel, and postal sectors.

¶14. (C) And these back of the envelope estimates ignore important counter trends to the movement toward greater state control. Whole swaths of the economy, our interlocutors again and again confirm, lie fully outside the ambitions of the state -- and are thriving. One seasoned businessman (who has had his hat handed to him on more than one occasion over the past 15 years) is back in Russia and growing fast, and he chalks up his current success to the booming service and retail sector, a place where he says he never comes in contact with the designs of the Kremlin. There are also instances, like with XXXXXXXXXXXX, where, despite the new ownership structure, the state has left the firm to run the business without Rosoboronexport grabbing off profits or instructing where production should go. Lastly, it would be irresponsible to ignore the progress being made toward the break-up and privatization of both the electricity and rail sectors. When all is said and done, these massive reforms will move some 2-3 percent of GDP from state to private hands.

¶15. (C) There is another reason why more of this economy will likely move into the private sector. Economic modernizers, as they have come to call themselves here, may still



ultimately get the upper hand. XXXXXXXXXXXX, XXXXXXXXXXXX, XXXXXXXXXXXX and others recognize that only through greater private sector participation in the economy will Russia be able to attract the capital needed to sustain growth over the long run. This is also where working to bring Russia into international institutions will help drive policy here in the direction we favor. Locking the Russian Government into such institutions and exposing Russian companies to the discipline of the global market will reinforce the trends we seek to encourage. Doing so this year, before the election process starts to create new winners and losers, is a bet on the modernizers worth taking.